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MEMORANDUM

AZ CORP COMMISSION  
DOCKET CONTROL

2012 OCT 3 PM 3 17

TO: Docket Control

FROM: Steven M. Olea  
Director  
Utilities Division

DATE: October 3, 2012

RE: IN THE MATTER OF THE APPLICATION OF ARIZONA TELEPHONE COMPANY TO DETERMINE EARNINGS OF THE COMPANY, THE FAIR VALUE FOR RATEMAKING PURPOSES, AND TO INCREASE RESIDENTIAL RATES AS NECESSARY TO COMPENSATE FOR THE RATE IMPACTS OF THE FCC'S USF/ICC TRANSFORMATION ORDER  
(DOCKET NO. T-02063A-12-0302)

Attached is the Staff Report for Arizona Telephone Company's application to increase residential rates as necessary to compensate for the rate impacts of the Federal Communications Commission's Universal Service Fund/Intercarrier Compensation ("FCC's USF/ICC") Transformation Order.

Staff recommends increasing Arizona Telephone Company's monthly weighted average residential local exchange service rate from \$9.25 to \$10.00.

SMO:AFF:kdh

Originator: Armando Fimbres

Arizona Corporation Commission

DOCKETED

OCT 03 2012

DOCKETED BY	<i>JSm</i>
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SERVICE LIST FOR: ARIZONA TELEPHONE COMPANY  
DOCKET NO.: T-02063A-12-0302

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Attorney for Arizona Telephone Company

**STAFF REPORT  
UTILITIES DIVISION  
ARIZONA CORPORATION COMMISSION**

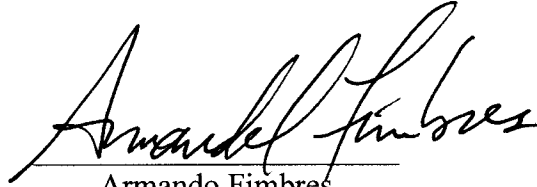
**ARIZONA TELEPHONE COMPANY  
DOCKET NO. T-02063A-12-0302**

**IN THE MATTER OF THE APPLICATION OF ARIZONA TELEPHONE COMPANY  
TO DETERMINE EARNINGS OF THE COMPANY, THE FAIR VALUE FOR  
RATEMAKING PURPOSES, AND TO INCREASE RESIDENTIAL RATES AS  
NECESSARY TO COMPENSATE FOR THE RATE IMPACTS OF THE FCC'S  
USF/ICC TRANSFORMATION ORDER.**

**OCTOBER 3, 2012**

## STAFF ACKNOWLEDGMENT

The Staff Report for Arizona Telephone Company (Docket No. T-02063A-12-0302) was the responsibility of the Staff member listed below.

A handwritten signature in black ink, reading "Armando Fimbres". The signature is fluid and cursive, with the first name "Armando" and last name "Fimbres" clearly distinguishable.

Armando Fimbres  
Public Utility Analyst V

**EXECUTIVE SUMMARY OF  
ARIZONA TELEPHONE COMPANY  
DOCKET NO. T-02063A-12-0302**

On July 5, 2012, Arizona Telephone Company (“Arizona Telephone” or “Applicant”) filed an application for a determination of its earnings and the fair value of its investment and requested that its residential rates be increased as necessary to compensate for the rate impacts of the Federal Communication Commission’s (“FCC’s”) November 18, 2011, Universal Service Fund/Intercarrier Compensation (“USF/ICC”) Transformation Order (“USF/ICC Order”) pursuant to Arizona Revised Statute (“A.R.S.”) § 40-250 and the Arizona Corporation Commission’s (“Commission’s”) Arizona Administrative Code (“A.A.C.”) R14-2-103.

Staff recommends that the Arizona Telephone monthly residence local exchange rate increase from the weighted average residential local service rate of \$9.25 to \$10.00 to address the impact of the FCC’s USF/ICC Order. Staff believes the proposed increase is just, fair and reasonable for the following reasons:

- The increase is necessitated by the FCC’s November 18, 2011 USF/ICC Order;
- The increase is necessary to preserve the entirety of the Federal Universal Service Fund (“FUSF”) funds that may flow to Arizona Telephone pursuant to the FCC’s rules;
- The increase will minimize/reduce the amount of future rate increase; and
- The increase will allow the Applicant to receive matching funds from the FUSF.

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## **Introduction**

On July 5, 2012, Arizona Telephone Company (“Arizona Telephone” or “Applicant”) filed an application for a determination of its earnings and the fair value of its investment and requested that its residential rates be increased as necessary to compensate for the rate impacts of the Federal Communication Commission’s (“FCC’s”) November 18, 2011, Universal Service Fund/Intercarrier Compensation (“USF/ICC”) Transformation Order (“USF/ICC Order”) pursuant to Arizona Revised Statute (“A.R.S.”) § 40-250 and the Arizona Corporation Commission’s (“Commission’s”) Arizona Administrative Code (“A.A.C.”) R14-2-103. A.A.C. R14-2-103(A)(1) requires specific financial and statistical information be filed with a request by a public service corporation doing business in Arizona for a determination of the value of the property of the corporation and of the rate of return earned. Arizona Telephone submitted, as recommended by Staff, a streamlined filing in which Arizona Telephone submitted the following six exhibits to support the requested increase in residential rates:

- Adjusted 2011 Results
- Adjustments
- Year 1 FCC Order ICC Impact
- Rate Base
- Working Capital
- Rate Design.

## **Background**

Arizona Telephone is a corporation duly organized and existing under and by virtue of the laws of the State of Arizona. Arizona Telephone is authorized to engage in and is engaged in the conduct of a general communications business within the State of Arizona. The Commission last considered Arizona Telephone’s rates in Docket No. T-02063A-97-0329, which resulted in Commission Decision No. 60722, dated March 23, 1998. Arizona Telephone is a small rate-of-return (“RoR”) regulated incumbent local exchange carrier (“ILEC”).

On November 18, 2011, the FCC issued the USF/ICC Order. The USF/ICC Order transitions the outdated federal universal service programs and most intercarrier compensation systems into a new Connect America Fund (“CAF”). The FCC’s press release characterized the USF/ICC Order as “the most significant policy step ever taken to connect all Americans to broadband.”

In its USF/ICC Order, the FCC stated that it will reduce intercarrier compensation rates to zero by July 1, 2020, for RoR companies, with limited recovery from customers and partial recovery from the CAF. The recovery from the CAF will phase out over time at 5 percent annually. The USF/ICC Order adds new rules that will reduce federal high-cost loop support

("FHCLS") to carriers by the amount their flat-rate residential local service rates fall below a specified local service rate floor. The rate floor includes state subscriber line charges, state universal service fees, and mandatory extended area service charges, if any are assessed. The FCC's order establishes residential local service rate floors of \$10.00 as of June 1, 2012, \$14.00 as of June 1, 2013, with the floor thereafter being determined annually by the FCC's Wireline Competition Bureau, based on a nationwide average.

To maintain FHCLS, Arizona Telephone and other rural ILECs must increase residential local rates to the FCC-mandated residential rate floors. Otherwise, the amount of FHCLS funds will be reduced dollar-for-dollar for each customer by the difference between the existing local rate and the new rate floor. If local rates are not increased, the new FCC rules will reduce FHCLS for Arizona Telephone and other applicable ILECs.<sup>1</sup>

### **Consumer Services**

On October 3, 2012, the Records Section of the Corporation Division responded that Arizona Telephone is in Good Standing. A review of Consumer Services database revealed that no complaints, inquiries and opinions were received pertaining to Arizona Telephone for the period January 1, 2009-October 2, 2012.

### **Compliance**

A check of the Utilities Division Compliance Section database showed that Arizona Telephone is in compliance with all items.

### **Operating Income Statement**

Arizona Telephone submitted Regulated 2011 Results of Operations information in its streamlined filing. The submitted information was accepted without adjustment for the purposes of this streamlined application.

#### ***Operating Revenue and Expenses***

According to the information provided by the Applicant, Arizona Telephone Total Intrastate Operating Revenues for 2011 were \$1,161,899. Subcategories of Total Intrastate Operating Revenues are noted below:

Local	\$594,185
USF-HCL <sup>2</sup> & Safety Net	\$106,060
Access Revenues	\$404,962
Other	\$56,692

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<sup>1</sup> Arizona Telephone is the only ILEC in Arizona with residential rates below \$10 receiving FHCLS.

<sup>2</sup> Universal Service Fund – High Cost Fund



The Company also provided information that stated that its Total Intrastate Operating Expenses for 2011 were \$1,835,077. Subcategories of Total Intrastate Operating Revenues are noted below:

Plant Expenses	\$586,601
Depreciation & Amortization	\$618,422
Customer Operations	\$240,450
Corporate Operations	\$317,237
Taxes	\$72,367

### ***Operating Income***

As provided by the Applicant, Arizona Telephone Total Intrastate Operating Income for 2011 was negative \$673,178 before taxes and negative \$407,067 after taxes.

### **Rate Base**

According to Arizona Telephone, the Interstate and Intrastate rate base is \$4,440,438, as stated in the table below:

#### **Arizona Telephone Company**

Rate Base

As of December 31, 2011

	Total Company	INTERSTATE	INTRASTATE
Plant in Service	\$ 20,979,008	\$ 9,607,775	\$ 11,371,233
Accumulated Depreciation	(17,074,428)	(8,111,016)	(8,963,412)
Net Plant in Service	\$ 3,904,580	\$ 1,496,759	\$ 2,407,821
Plant Under Construction	288,948	132,387	156,561
Material & Supplies	36,509	11,018	25,491
Deferred Income Taxes	(282,561)	(130,194)	(152,367)
Cash Working Capital	162,962	83,781	79,180
Rate Base	\$ 4,110,438	\$ 1,593,751	\$ 2,516,686

### **Customer Base**

Arizona Telephone reported 2,036 residential lines and 770 business lines in its April 15, 2012 Utilities Annual Report.

### **Revenue Requirement**

As stated above, the Applicant's filing was based on a streamlined basis and rates will not be set based on rate of return regulation. Therefore, the Applicant's filing does not contemplate rate adjustments based on revenue requirement analysis.

### **Rate Design**

The Applicant did not propose a rate design as required by R14-2-103. The Applicant is seeking to increase its weighted average residential local exchange service rate by \$0.75.<sup>3</sup> The Applicant's filing only contemplates changes to residence local exchange rates to compensate for the rate impacts of the FCC's USF/ICC order. With this filing, Staff will only address the monthly increase of all residence local exchange service rates to \$10.00.

### **Staff Analysis**

Staff did not perform a regulatory audit of the information submitted by Arizona Telephone. However, Staff reviewed the information filed in the context of the FCC's November 18, 2011 USF/ICC Order which is intended to transition the outdated federal universal service programs and most intercarrier compensation systems into a new CAF.

Staff has analyzed this application in terms of whether there were fair value implications. For the purposes of this matter the Applicant stipulated to the use of original cost less depreciation as the basis for a determination of its fair value rate base. The Applicant states that its intrastate rate base is \$2,516,686. The Applicant provided information that indicates that its Total Intrastate Operating Revenue for 2011 was \$1,161,899. According to the Applicant, the annual revenue effect of the increase in local telephone service rates to \$10.00 is \$18,409. Compared to the Applicant's total revenues, any revenue impact from this rate increase would be small and any impact on the Applicant's fair value rate base would be de minimus. Arizona Telephone's Operating Income would remain negative, therefore, the rate of return is not meaningful in this case, i.e., less than zero.

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<sup>3</sup> According to Arizona Telephone's Rate Design Exhibit, it currently provides One-Party service to 2,031 Residential customers and Four-Party service to 5 Residential customers.

**Staff's Recommendations**

Staff recommends that the Arizona Telephone monthly residence local exchange rate increase from the weighted average residential local service rate of \$9.25 to \$10.00 to address the impact of the FCC's USF/ICC Order. Staff believes the proposed increase is just, fair and reasonable for the following reasons:

- The increase is necessitated by the FCC's November 18, 2011 USF/ICC Order;
- The increase is necessary to preserve the entirety of the FUSF funds that may flow to Arizona Telephone pursuant to the FCC's rules;
- The increase will minimize/reduce the amount of future rate increase; and
- The increase will allow the Applicant to receive matching funds from the FUSF.

Staff has reviewed the rate application and the federal rule changes that have prompted the rate application. Staff concludes that the costs appear reasonable and appropriate under the unique circumstances of this case. However, Staff's recommendation in these unique circumstances should not be viewed as precedent for the processing of future rate case applications.